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Executive Compensation

Rikka Damme-Soronen and Shelly McCarron

As part of a corporate governance business economics project, we researched current issues in executive compensation. Our analysis is based on current scholarly research, industry insight, conference proceedings, interviews with executives and directors, and a broad literature review. Our research reveals a growing disconnect between executive compensation and firm performance.

The board of directors' most fundamental responsibility is to protect shareholder interests. Additionally, due to the enormous price tag of most CEOs, hiring the CEO is a critical board decision. By selecting, hiring, and paying management, boards have the power to create and destroy wealth. A solid board of directors, representing the most fundamental long-term interests of the shareholders, ensures that a rational compensation program is in place.

Executive compensation issues focus on the level of pay and the sensitivity of pay to performance. Our research reveals that cash compensation has more than doubled since 1970, and total realized compensation, including gains from exercising options, has more than quadrupled. Stock options are the fastest growing component of CEO compensation. Furthermore, stock-based compensation has not been shown to align management interests with shareholders; however, it has become a significant source of wealth for executives.

Overall, we found that CEOs are paid more when the board is less effective, and that this combination also results in lower operating and stock return performance. Specifically, CEO compensation is inversely related to the percentage of the board composed of inside directors. Our research also revealed that CEO compensation is an increasing function of several factors including: board size, the percentage of the board who are outside directors appointed by the CEO, the percentage of outside directors who serve on three or more other boards, and whether the CEO is also the chairman.

Stock-option compensation policies overlook management's ability to reprice options if the firm does not meet its performance goals. Similarly, stock restorations, or reloads, also present executives with another potential conflict of interest. When options with reloading benefits are exercised, they are automatically refilled, and the recipient receives a new set of options. Reloads substantially reduce the holder's financial risk—a risk reduction that shareholders obviously do not enjoy. Executives can also ensure that the options are in-the-money by increasing the market price of the stock through buybacks.

Another complication of stock options is related to the short-term and long-term goals of the company. The pressures to continue to make earnings goals each quarter without sacrificing the future is a precarious balancing act. Tying compensation to short-term results only serves to guarantee that management is shortsighted. A potential solution is to gear options toward longer-term results; if the stock does not reach a certain level by a predetermined period of time, the options become worthless. This would ensure that management's focus expand beyond a quarterly time frame. Currently, stock option compensation has a financial accounting advantage; firms are not required to expense the value of the stock option grants on the income statement, rather the options are disclosed in the footnotes using the Black-Scholes option-pricing model. For an average company in

continued on page 5

From the editor . . .

Ethics and social responsibility have always been an important part of the curriculum at the Leeds School of Business. Recent scandals in major corporations illustrate the relevance of teaching these topics. This issue of the *Colorado Business Review* focuses on one of many effective approaches used by professors within the Leeds School of Business and some student findings and opinions.

Richard L. Wobbekind

A New Face of Corporate Governance?

Robby Oad, Jason Rich, Oscar Starnes, and Louis Battaglia

Corporate creditability has gained attention in the United States recently. Scandals such as accounting fraud and financial statement misinterpretation have swept across the nation during a time of uncertainty in our economy. Scandals with Enron and WorldCom have inspired reaction from the U.S. Congress. As of July 30, 2002, the Sarbanes-Oxley Act will outline responsibilities with respect to auditors, accounting practices, and corporate executives, as well as establish a corporate oversight committee. Although the act addresses some aspects of corporate irresponsibility, it in no way offers proper resolution to the dilemma at hand. In fact, it may serve to heighten confusion in the business world and in turn, new questions relating to corporate governance will surface.

A sizeable portion of the Sarbanes-Oxley Act states that a new corporate oversight board is to be initiated. The question that has been raised is whether or not this board will have any significant long-term impact above and beyond the existing government agencies that currently monitor corporate accounting procedures. Most probably, no! This act will likely have a purely short-term impact on the existing system. The ideas presented in the corporate governance act merely restate the laws set forth in the Securities Exchange Act of 1934. It does increase the penalties leveled against perpetrators of accounting fraud; however, these activities have been illegal for 68 years and are still being disregarded. Arguably, the idea of passing a new law to remind us of the old one is not the most effective measure to ensure compliance from corporations trying to beat the system. It is also important to consider what message this is sending to existing government agencies that currently oversee corporations. We have effectively relied on the capabilities of the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and other entities for decades. Are they to be replaced by this new board? Will there be open communication among these new bodies or will they butt heads in petty territorial disputes?

One of the major reasons for the act is corporations' creative methods in their accounting procedures. But in light of the new act, how can the SEC or any government agency effectively audit the books of a given corporation? The establishment of the new Public Accounting Oversight Board is a key section of the act, but it is difficult to see how it can efficiently and effectively regulate corporations' accounting policies. It has already been speculated that the five-member board will handle registration of all public corporations in the United States, but only oversee and investigate few if any of them unless a concern is brought to their attention. The act, intended to protect the public and their investments from corporate fraud, is not going to be successful relying only upon the oversight board. Once it is made public that a company is under investigation, its stock will fall similarly to that of Enron or WorldCom when the SEC announced it was investigating the corporations. There is no real investor protection in the act, only increased threats of jail time to governing boards who partake in such actions.

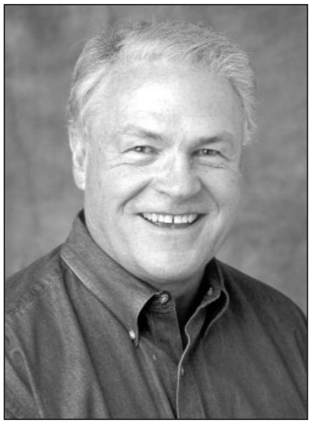
Arguments for the act suggest that it encourages financial responsibility from the top officials and boards of directors heading the business. Corporations are feeling pressure to comply and follow ethical financial standards from public awareness. Warren Batts, former chairman and chief executive of Premark International Inc., doesn't agree with the new act. As quoted in the *Wall Street Journal,* he stated that "this will serve as an administrative burden for companies who are doing the right thing." Mr. Batts adds that the new provisions also hinder chief executives from doing their jobs. Instead of overseeing employees and customers, more time will be spent ensuring their policies and numbers are accurate. Jeffrey E. Garten, dean of Yale School of Management, worries that the act will micromanage corporations. The result? "Business innovations will ultimately suffer." With respect to Mr. Batts, it is hoped that "business innovations" mean product diversity and capital investment plans, not financial statement abuse and accounting fraud!

Ultimately, a new business paradigm based upon accountability must be forged if the market is to function properly. Responsibility in this scenario should echo through all involved parties, whether an investor or a corporate CEO. The cycle of pressure on middle management and executives to meet quarterly earnings should be refocused into improving long-term corporate health. Furthermore, investors must be aware of their expectations of the stock market and to invest funds with more caution and scrutiny. The populace must realize that placing money in the market is not a sure bet and that it is important to invest in corporations bound by honesty and integrity. Although the complexity involved will be formidable, from an accounting perspective it is most important that financial reports be fundamentally trustworthy and clear and concise in order for investors to properly gauge the health of the company. Perhaps a "survival of the honest" mentality is the new standard by which all companies should be upheld.

Robby Oad is studying finance and economics; Jason Rich is an information systems and history major; and Louis Battaglia is studying finance, all in the Leeds School of Business at CU-Boulder. Oscar Starnes is an economics major in the College of Arts and Sciences at CU-Boulder.

Teaching Corporate Social Responsibility

John Garnand



This issue of the *Colorado Business Review* addresses the question of corporate social responsibility and the recent Sarbanes-Oxley Bill that was signed into law by President Bush. This is the congressional response to the unending stream of corporate miscreants from Enron, Arthur Andersen, WorldCom, Qwest, Xerox, Tyco, etc. The accounting scandals of these gigantic companies have driven consumer confidence into a tailspin and rocked the already depressed markets on Wall Street—not to mention the unsettling consequences on those unfortunate employees who have been laid off or forced to postpone their dreams of early or normal retirement.

For 18 years I have been teaching a course to seniors at the University of Colorado that studies the synergies that exist and influence the relationships between business, society, and government—moving from the earlier and more anecdotal approach we called "business ethics" to the more recent and broader focus on "corporate social responsibility."

This summer I challenged my students to dig into the cases that we are reading about daily in the *Wall Street Journal* or watching on television, analyze what has gone wrong, and come up with scenarios or conclusions about the future. This naturally led to the study of reforms for corporate governance, and ultimately to the Sarbanes-Oxley response. The two preceding articles summarize student findings and opinions on these matters.

*The CONTEXT question: What do students gain from the study of ethics? Or more precisely, **when** should students study ethics or corporate social responsibility?*

The University of Minnesota has conducted studies that provide us with an answer. In the development process of individuals, there comes a critical point when they leave the protection and nurturance of the home and move out into the world on their own. For many, this occurs when they leave home to attend college. Now they must make decisions that drive their actions, away from the protection of mom and dad, and learn that their decisions and actions *have consequences* they cannot escape. Their parents can no longer bail them out. Now on their own for the first time, they must live with the consequences of their choices. The conclusions of this study show the first real tests of ethical behavior and choice come between the ages 18 and 24.

"Now on their own for the first time, they must live with the consequences of their choices."

It is my position that juniors and seniors, who are beyond the extended high school mentality of freshmen and sophomores and are focusing on the imminent prospect of going out into the business world of work, begin to make decisions and initiate actions that solidify their decision rules. My experience corroborates the findings of the Minnesota studies. Students may learn their values and morals at an earlier age, but the critical time of testing these principles and decision rules is within the 18- to 24-year-old age bracket, when career-defining choices are being made and consequences of actions can no longer be escaped.

*The CONTENT question: **What** should be taught at this point in the students' development?*

The undisputed father of capitalism is Adam Smith, who wrote between 1759 and 1776. His now universally famous *The Wealth of Nations* spawned a discipline called economics, and formulated his well-known principles of "supply" and "demand" and "economic self-interest" that have guided the development of various versions of capitalism and "free enterprise" after his time.

What is interesting about this tome is that although he is describing the practices of commerce of his time, there is not a single line in *The Wealth of Nations* that is *complimentary* of business practices. He uses such phrases as "nobody ever saw a dog make a fair and deliberate exchange of one bone for another with another dog" and "people of the same trade rarely meet together, but the conversation ends in a conspiracy against the public" to describe business. His reluctant conclusion is that (as a default) if businesses act in their own self-interest, an "invisible hand" will smooth out the overall roil of the interactions and lead to the enhanced well-being of society.

Adam Smith wrote *two* books! His famous *The Wealth of Nations* was preceded by a lesser known book entitled *A Theory of Moral Sentiments* (1759). In this earlier book, Smith espoused the moral principle of empathy—a feeling of bonding with one's fellow humankind. He did not mean "sympathy" (feeling *for* you) but "empathy" (feeling *with* you)—very similar to the Golden Rule of

continued on page 4

Teaching Corporate Social Responsibility, *continued from page 3*

"do to others as you would have them do to you." Adam Smith intended empathy to be the a priori condition against which the dicta of his *The Wealth of Nations* should be understood and applied. "Supply and demand" and enlightened "self-interest" practiced in the context of empathic feeling for the well-being of others would lead to the overall improvement of society and the creation of legitimate wealth for its practitioners. An open-market society succeeds when we are all concerned about our collective well-being.

What specific decision rules do you think will help develop students' understanding of ethical choices and corporate responsibility?

I have developed a little model of decision rules that should guide the generality of business decisions, and that is simple enough for students to remember and apply in real world situations they will encounter. These rules are very American, based on our core documents—the Constitution and Bill of Rights—that define our version of capitalism.

Any time one is confronted with making a business decision that has consequences, apply the following decision rules in this order:

RULE 1: Is this decision/action *legal?* If it is not legal, you have a new set of business risks and consequences to consider. If you do not know, stop! Find out!

RULE 2: Is this decision/action *right?* Tougher question. Does it respect the moral rights of the stakeholders who will be affected by it? Is it fundamentally fair? Does it add value to the company, to society?

RULE 3: Can this decision/action withstand *disclosure?* Would you do this if it was to be reported in the press? Would you tell your mom or your spouse about the decision?

Ethical decisions are not easy decisions. Frequently, they are not between what is "right" and what is "wrong," but between two "rights"

"Many ethical decisions are lose-lose, but they must be made. This is the everyday meaning of courage and heroism."

that each have negative consequences for some parties. Do you lay off people based on seniority? Or productivity? Or perceived lack of value to the company? Many ethical decisions are lose-lose, but they must be made. This is the everyday meaning of courage and heroism. This is the street meaning.

The RELEVANCE question: Why study this ***now?*** *Are courses in ethics or social responsibility the answer to our corporate troubles? Are these studies educationally transferable to real life?*

No one should be deluded nor should false claims be made for studies of corporate social responsibility or business ethics. Studies do not always translate into practice, especially in light of the pressures to perform that business imposes. But studies change the way something is perceived and approached, the way something is thought about. This is what "taking ethics to the streets" means—it's a way of thinking about something.

I would like to answer this question by quoting Mark Pastin *(Gaining the Ethics Edge)*:

> "Buried beneath the charts of organizational responsibility, the arcane strategies, the crunched numbers, and the political intrigue of every firm, are the ground rules by which the game unfolds.
>
> ...the thinking manager uses ethics to ask questions and to create opportunities. He observes—reverse engineering from actions to decisions, from decisions to premises, from premises to assumptions. By so doing, he learns WHY he and others do what they do, WHAT to anticipate from himself and others, what moves are possible (or appropriate)."

The study of ethics lets students see the world with new eyes.

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Looking to CU for Ethics Instruction

Anne Sandoe-Thorp

Long before Enron, Arthur Andersen, Imclone, and WorldCom became synonymous with corporate greed and unethical business practices, business schools have typically offered courses that included some form of ethics training. In fact, the Association to Advance Collegiate Schools of Business (AACSB) requires their member schools to include such courses as part of its accreditation process.

Historically, many schools have integrated the teaching of ethics into such classes as Business and Law, Business and Society, or International Business. The recent string of corporate scandals has caused business and education leaders to reevaluate the way in which prospective leaders are taught to manage their businesses in a socially responsible manner. One of the outcomes of this reevaluation is that colleges and universities are being expected to enrich their programs in these areas.

The Leeds School of Business has stepped to the forefront by strengthening its business curriculum. It offers new courses directly related to corporate ethics. The creation of these courses has been fostered by grant money provided from the $35 million gift from the Leeds family. This commitment to the teaching of socially responsible businesses is not a passing fad. Both the business school and the Leeds family, who have provided funding for the development of these of other related projects, had a commitment to social responsibility before it was popular.

Naomi Soderstrom, associate professor of accounting, is developing a course for seniors that will likely be called, "Emerging Accounting Issues." This course will include discussions of the accounting practices and manager incentives used by Enron and WorldCom and touch on the role of auditors and how they should address improper practices and incentives.

Similarly, Jeffrey Luftig, senior instructor of operations management at CU-Boulder is preparing a new course entitled, "Ethics and Decision Making in Business Management." This course will focus less on the high-profile problems that have recently dominated the news and dwell more on the decision making that surrounds employees,

continued on page 6

Executive Compensation, *continued from page 1*

the S&P 500, expensing stock options would cause earnings to shrink by about 10%. Therefore, many questions are raised for companies where stock options are more prevalent.

In theory, academics' idea of linking compensation to performance through stock options provides a powerful incentive for management to ensure that their companies are profitable. However, in practice, it is more complicated. How should firms account for stock options without overly complicating the accounting system? Should firms expense the options at the time of grant or exercise? What if the value of the shares falls during the vesting period? Furthermore, what about the price-to-earnings ratio? Will fully diluted earnings change the fundamental meaning of the P/E ratio? Regardless, powerful stakeholders are already moving to require votes on certain equity compensation plans if they could result in material dilution of shareholders' stock.

Also at issue is whether expensing stock options will stifle innovation. The income statement effect of expensing options would make it difficult to attract investment capital, which would also impact the firm's ability to entice talent. The implications of this policy will affect many industries, especially bio-tech and high-tech firms.

Coca-Cola recently announced its intention to begin expensing options. The company will adopt the fair value method on the date the options are granted. Coke is in a better position to do this than others as few of its employees have stock options relative to the shares outstanding. It is estimated that expensing stock options will result in only a one-cent drop in the company's earnings per share. Each company will need to evaluate the multifaceted risks involved with implementing a similar system as expensing stock options is only one of several proposed compensation reforms.

Academic proposals for compensation reform and increasing investor protection include establishment of smaller, outsider controlled boards; separation of the CEO and chairman; and expensing stock options using the Black-Scholes method. Executives, institutional investors, and regulators believe the answers lie in full disclosure to shareholders, a focus on long-term results, and using the fair value method to expense options. While the two groups' recommendations differ slightly, the effects of each proposed reform warrant a thorough investigation prior to its implementation.

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Looking to CU,
continued from page 5

suppliers, customers, and shareholders on a day-to-day basis.

In addition, four more ethics-based classes are being developed. As part of their requirements for graduation, undergraduate students will be required to take two courses and all MBA students will be required to take one course that discusses how socially responsible decision making is good for business and society. Also, faculty members are now required to focus at least one segment of their classes on ethics, and they will be encouraged to conduct ethics-related research.

Anne Sandoe-Thorp recently joined the Leeds School of Business as the director of MBA Admissions and Marketing. Previously, she served in a variety of similar positions at Duke's Fuqua School of Business.